No. 75-1068

In the Supreme Court of the United States

OCTOBER TERM, 1975

LEA ASSOCIATES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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The question in this federal income tax case is whether amounts petitioner paid for a competitor's business were properly allocated by the Commissioner of Internal Revenue between the seller's agreement not to compete and the capital assets of the business. It is settled that the purchaser of a going business may deduct the amounts paid to acquire a covenant not to compete from the seller over the life of the covenant. However, amounts paid for business assets including good will are capital expenditures which can only be ratably deducted through depreciation over the useful life of such assets if their useful life can be determined.

1. The undisputed facts are as follows: Prior to 1962, petitioner and Ken M. Davee were competitors in providing market research services to large drug manufacturers. The high cost of the market research services each provided limited their potential clients, and it became apparent that

the number of potential customers for this service was insufficient to support both petitioner's market report, the "National Drug and Therapeutic Index," and Davee's report, "Physicians' Panel." Accordingly, petitioner decided to purchase Davee's competing business in the hope of obtaining all or substantially all of Davee's subscribers (Pet. 6; Pet. App. 3a-4a, 18a-21a).

In 1962, petitioner offered to purchase Davee's "Physicians' Panel" for $350,000 (Pet. App. 22a). The proposed purchase price was acceptable to both parties from the beginning and the negotiations which followed focused on the terms of the sales agreement and the noncompetition agreement, which was to accompany the sale, and allocating the total purchase price between these two elements of the transaction (Pet. App. 22a-24a). The negotiations culminated in two contemporaneously executed agreements, a sales contract and a letter agreement (Pet. App. 24a). Under the sales contract (Pet. App. 36a-43a), petitioner agreed to buy Davee's "Physicians' Panel" for $320,000, payable in installments.[1] In the separate letter agreement (Pet. App. 44a-45a), petitioner agreed to pay $30,000 for a five-year covenant by Davee and his wife not to compete with petitioner.

On its 1962 tax return, petitioner claimed deductions for all amounts it paid Davee under both the sales contract and the letter agreement (Pet. 7). On audit, the Commissioner of Internal Revenue disallowed the deductions for amounts paid under the sales contract and refused to allow any depreciation because the assets petitioner purchased did not have a definite useful life. However, the Commissioner permitted petitioner to amortize the $30,000 allocated to the covenant over its five-year term. The Commissioner also asserted deficiencies against Davee, whose

[1]Petitioner also agreed to pay an additional $37,500 if Davee promptly accepted the offer, which Davee did (Pet. App. 40a).

refund suit was consolidated with this case (Pet. App. 14a, 31a). In this refund suit brought by petitioner,[2] the Court of Claims upheld the Commissioner's determination that amounts petitioner paid under the sales contract were nondeductible capital expenditures (Pet. App. 1a-33a).

2. When the purchase of a business is accompanied by the seller's execution of a covenant not to compete, it is generally in the buyer's interest to allocate the greatest possible portion of the purchase price to the covenant because such amounts are deductible over the life of the covenant. However, because such amounts are taxable as ordinary income to the seller, it is in the seller's interest to allocate the smallest possible portion of the purchase price to the covenant not to compete. Conversely, it is in the seller's interest to allocate the greatest possible portion of the purchase price to the capital assets of the business since the gain from the sale of such assets is taxable at preferential rates.

Because of the competing tax interests of buyer and seller in such a situation, the courts have generally accepted an allocation of price to which the parties have agreed in arm's-length negotiations. Thus, the courts have held that, absent "strong proof"[3] that the agreed allocation totally lacks economic reality or a showing that the agreement was the product of fraud, mistake, or undue influence,[4] for tax

[2]Because petitioner's taxable year 1962 was already the subject of a refund suit in the Court of Claims, the government asserted the deficiencies at issue by a counterclaim.

[3]See, *e.g.*, *Commissioner* v. *Danielson*, 378 F.2d 771 (C.A. 3), certiorari denied, 389 U.S. 858; *Dakan* v. *United States*, 492 F.2d 1192 (Ct. Cl.).

[4]See, *e.g.*, *Ullman* v. *Commissioner*, 264 F.2d 305, 308 (C.A. 2); *Montesi* v. *Commissioner*, 340 F.2d 97 (C.A. 6); *Barran* v. *Commissioner*, 334 F.2d 58 (C.A. 5).

purposes the parties are bound by the terms of their agreement.

The Court of Claims below properly applied this well-established rule to the facts of this case. Here, petitioner and Davee engaged in arm's-length negotigations with respect to the allocation of the total price of $350,000 between the business assets and Davee's covenant not to compete (Pet. App. 3a-4a, 22a-24a). These negotiations resulted in two agreements—a sales agreement under which petitioner agreed to pay $320,000 for the business and a separate letter agreement calling for the payment of $30,000 for the five-year covenant not to compete.

The Court of Claims correctly accepted the allocation reflected in these arm's length, freely-executed agreements, as the best evidence of the parties' intent. Moreover, the court had the benefit of the evidence offered by both parties (petitioner and Davee) in support of their respective positions, since both parties participated in this consolidated proceeding. Since the evidence showed that petitioner entered into the agreements with a full awareness of the legal and tax consequences that attached to the price allocations and not as the result of any fraud, mistake or undue influence, the court correctly held petitioner to the terms of its bargain.[5]

In renewing its argument made below (Pet. App. 11a) that the entire purchase price paid for the business should be allocated to the agreement not to compete, petitioner relies (Pet. 6) on Section 4 of the sales agreement (Pet. App. 37a-38a), in which Davee agreed not to solicit

[5]Contrary to petitioner's assertion (Pet. 9), there is no conflict with *Williams* v. *McGowan*, 152 F.2d 570 (C.A. 2), or *Watson* v. *Commissioner*, 345 U.S. 544. Those cases hold that a purchase price should be apportioned among the assets and rights acquired, which is exactly what the court below did.

reports or data from physicians. However, as the Court of Claims correctly noted (Pet. App. 12a-13a), the limited restrictions contained in Section 4 of the sales agreement, standing alone, would not have been sufficient to prevent Davee from competing with petitioner through the use of an agent. Thus, the broader restrictions against competition contained in the letter agreement were the source of petitioner's protection against future competition from Davee.

At all events, the fact that the parties agreed to execute a separate covenant not to compete and allocate $30,000 of the purchase price to it demonstrates that the covenant had independent significance to them. Thus, the history of the parties' negotiations shows that, pursuant to Davee's counter offer (Pet. App. 6a), the separate letter agreement was intended to be the operative contract not to compete. Under Davee's counteroffer, $30,000 of the proposed $350,000 sales price was to be allocated to the covenant (see Pet. App. 6a). On these facts, the Court of Claims correctly concluded that the letter agreement calling for the $30,000 payment for what is referred to in the evidence of the negotiations (Pet. App. 24a) as Davee's promise "guaranteeing non-competition," represented the parties' allocation of a portion of the purchase price to the covenant not to compete. As the court observed (Pet. App. 11a), petitioner's allocation of the total purchase price to the covenant not to compete is extreme and would necessarily constitute an unwarranted revision of the parties' agreements.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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